2.03 Revenue Recognition Step 3

3. Determine the Transaction Price

The transaction price is the amount of consideration that the entity *expects* to be entitled to in exchange for transferring goods/services in a satisfactory manner, excluding amounts to be collected on behalf of others, such as sales taxes. There are many factors that will affect the amount of revenue that is recognized.

- Whether the reporting entity is a **principal or an agent** in the transaction will affect whether the gross or net amount of revenues is recognized.
- **Variable consideration** (eg, discounts, rebates, etc.) may be estimated and included or may be excluded and recognized in the period earned.
- **Time value of money** – Amounts may be reported at their present values when there are potentially lengthy periods between satisfaction of the performance obligations and the transfer of funds.
- There may be **nonmonetary consideration** (eg, shares of stock) requiring measurement.
- The seller may be **providing consideration to the customer**.

Principal Versus Agent Considerations

When more parties than a seller and a buyer are involved in revenue-related transactions involving contracts with customers, the roles of the parties must be understood to determine the amount of revenue to be recognized by each party.

- When the seller is a **principal** in the transaction, the entire amount of revenue will be recognized and amounts paid to third parties will be recognized as expenses or as a component of cost of sales.
- When the seller is an **agent**, only the net amount of revenue to be retained after paying the principal is recognized.
    - A principal has the obligation to provide goods/services.
    - An agent has the obligation to arrange for another party, the principal, to provide goods/services.

To distinguish between a principal and an agent, a significant factor to consider is **who has control** of the goods/services that are the subject of the contract before they are transferred to the customer.

- A principal controls goods/services before the transfer and may either satisfy the performance obligation or may engage another to do so.
- The fact that a party obtains control of the goods and immediately transfers them to a customer does not constitute control.
- A principal has control of:
    - Goods or assets obtained from another party and transferred to the customer
    - Rights to a service to be provided by another party at the direction of the principal

    - Goods/services obtained from other parties to combine with other goods/services to satisfy a performance obligation (eg, chocolate and wine combined to create a gift basket)
- Indications of who has control of goods/services prior to transfer to the customer include:
    - *Primary responsibility* for providing goods/services to the customer
    - *Risk of loss* associated with inventory both before delivery to the customer and after delivery to a customer, such as when a customer returns goods
    - *Authority to set prices* for the goods/services

Similar to the relationship between a principal and an agent, a seller may collect funds on behalf of a third party, such as when a sale is subject to state sales tax, which is collected by the seller and remitted to the taxing authority. These funds are not considered part of the consideration in a contract.

Variable Consideration

Variable consideration may result from discounts or rebates provided to buyers; credits, price concessions, or incentives; performance bonuses; or penalties. Variable consideration may also result from contingencies, such as the occurrence or nonoccurrence of a future event, or a performance bonus based on achieving a milestone.

Variable consideration is a factor when either:

- The customer has a valid expectation that the seller will accept less than the contract amount in the form of a discount, rebate, refund, credit, or other price concession; or
- Facts indicate that the seller intended, as of the inception of the contract, to make a price concession.

Variable consideration is estimated at the inception of a contract and is included in the total consideration to be earned through the satisfaction of all performance obligations. The amount will be estimated, applying one of two approaches:

- Under the **expected value approach**, different amounts that will be obtained based on various levels of performance will each be assigned a probability with the total of the probabilities equaling 100%. Each amount is multiplied by the probability of achieving it and the total is the expected amount of variable consideration.
- Under the **most likely amount approach**, different outcomes are each assigned a probability such that the total of the probabilities equals 100% and the outcome with the greatest probability of occurrence is assumed to be the amount that is to be recognized.

In a period in which cash receipts exceed the expected amount, the excess is reported as a refund liability.

The standard establishes a **constraint** on the amount of variable consideration that can be recognized. The constraint is designed to prevent an entity from recognizing revenues in one period only to be required to reverse it in a subsequent period. In applying the constraint, the entity should consider the likelihood and the magnitude of a potential reversal. Factors that increase the likelihood or the magnitude of a **potential reversal** include:

- Amounts that are susceptible to factors, such as market volatility, that are beyond the control of the entity.
- Uncertainties that are not likely resolved for long periods.

- Amounts due cannot be reliably anticipated due to a lack of experience or having experience that is not predictive.
- There has been the practice of making price concessions or changing terms and conditions.
- There is a wide range of possible consideration amounts.

Variable consideration is required to be reassessed each period such that the transaction price at the end of any given period reflects the circumstances at that time.

Time Value of Money

The time value of money is considered when measuring consideration if either the buyer or seller obtains a significant financing benefit. Such benefit may be due to a provision of the contract or because of a time lag (ie, generally more than one year) between performance and payment.

Financing is considered significant when there is a difference between the amount of consideration and the cash price for the goods/services. The effect will depend on the time lag between performance and payment and prevailing interest rates.

There is no financing component included in measuring consideration if:

- The customer paid in advance and the timing of performance is at the discretion of the buyer;
- Variable consideration is significant and is contingent on factors outside the control of the entity; or
- The difference between the amount of consideration and the cash price for the goods/services is due to factors other than financing and the amount is commensurate with some factor such as protection from nonperformance.

When the time between performance and payment is expected to be one year or less, no financing component is required.

When a financing component is included, it may be calculated using the discount rate that is applicable for separate financing transactions between the parties, or the rate at which the present value of the consideration is equal to its equivalent cash price.

- The financing component is recognized as interest income or expense, separate from revenues from customers; and
- Interest income or expense is only recognized to the extent that a contract asset or liability has been recognized.

Noncash Consideration

Noncash consideration (eg, shares of stock) is measured at *fair value.*

- When the fair value is not determinable, it will be measured by reference to the standalone selling price of goods/services exchanged.
- Resources contributed by the customer to assist the entity in satisfying a performance obligation is accounted for as noncash consideration if the entity obtains control.

Consideration Paid to a Customer

A seller may make a payment to a customer in cash, or in the form of a credit, coupon, or voucher.[2] It may also be paid to another party purchasing the entity's goods/services from the customer, such as in the form of a rebate.

When consideration paid to a customer is in exchange for distinct goods/services, it is accounted for as an asset or expense, as appropriate.

- If the amount paid exceeds the value of the distinct goods/services, the excess reduces the transaction price.
- If the value of the goods/services cannot be determined, the entire payment reduces the transaction price.

A reduction to the transaction price is recognized at the *later of*:

- The recognition of revenue resulting from the transaction, or
- The payment of the consideration to the customer or the promise to do so.

An entity enters a contract with Walmart to sell them $20 million of their products, but Walmart wants a $2 million payment upfront to reconfigure shelf space. The $2 million payment reduces the $20 million transaction price to $18 million since Walmart isn't providing a good or service in exchange for the $2 million. If the goods are to be transferred over 10 months, revenue of $1.8 million [($20M -$2M)/10] will be recognized for each delivery.

Nonrefundable Upfront Fees

Nonrefundable upfront fees are often intended as compensation to the seller for an activity performed near the inception of the contract. Since amounts received are only recognized in income when a performance obligation has been satisfied, upfront fees are generally considered part of the total consideration and are allocated among distinct performance obligations.

For example, a health club membership fee is charged to cover the administrative costs of setting up the contract. The customer does not obtain anything of value at this point. Since the value to customer is the use of the facility, the membership fee is recognized over the course of the contract.

Sale with Right of Return

Goods may be sold under terms that allow the customer to return the goods for a refund. In this case, the entity recognizes revenue in an amount equal to the portion that is expected to be retained by the entity.

- Estimated amount of returns are recognized as a *refund liability*.
- Right to recover goods from the customer is recognized as an *asset*.

[2] Consideration payable to the customer may also include equity, which is accounted for under ASC 718 as share-based payments (discussed in a later section).

Assume an entity sells the customer $100 of goods and they have 90 days to return the merchandise. If the seller expects that 20% will be returned, they will record:

Cash (or A/R)	80	
Right to recover goods	20	
Sales revenue		80
Refund liability		20